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TAGS: ECON ETRD EINV EAGR ET
SUBJECT: ETHIOPIA: INFLATION AT RECORD LEVELS

¶1. SUMMARY: Except during episodes of drought and macroeconomic shocks, Ethiopia historically has seen low rates of inflation. However, the recent rise in inflation, especially food inflation, during times of good agricultural output run counter to historic trends. The Government of Ethiopia (GOE) has taken measures including instituting a surtax and raising civil service salaries to combat the effects of rising prices, but the effects are questionable. END SUMMARY

UNUSUAL INFLATION

¶2. Food items (mainly cereals) constitute over 60 percent of the weight in the computation of Ethiopia's Consumer Price Index (CPI). Historically, bumper crops lead to low inflation while droughts and other shocks that lead to reduced agricultural output raise grain prices and put pressure on inflation. Thus, trends in the CPI largely depend on productivity in agriculture and its seasonality which is less controllable by fiscal and monetary policy stance.

¶2. The CPI in the past two years was however in paradox to this historic trend. Official statistics indicate that, on the average, agricultural value added grew annually by 14 percent in the past three years while annualized moving average CPI inflation rose steadily, reaching 18 percent in July 2007. People on a fixed income bear the brunt of the inflation. In an effort to curb the rise on prices, the GOE has been trying to understand its causes and taking counter measures. The GoE's principal policy responses include 1) levying a surtax and using the proceeds to purchase subsidized wheat for distribution to the urban poor and 2) raising salaries of civil servants. The surtax appears to have been inconsequential as prices are still on the rise while the impact of the salary revision remains to be seen as it was implemented very recently.

POSSIBLE CAUSES OF THE PRICE ESCALATION

¶3. Different explanations are given by the GOE, opposition parties, the IMF, and individuals for the steady rise in the inflation rate. The GOE argues that the prevailing inflation came about due to demand side pressures. According to the GOE, factors contributing to excess demand include an increase in farmers' income, a shift in production by some farmers towards production of cash crops mainly for exports (thus shifting from producers to consumers of cereals and increasing demand), hoarding grains for speculation,, merchants expecting higher profit margins, the export of cereals, and an increase in the prices of imported commodities.

¶4. Some institutions and individuals also focus on the demand side. They argue that GOE intervention in grain marketing, hoarding, reliability of the official growth statistics (particularly, agricultural value added data which are based on pre-harvest

estimates and subject to biases), monetary expansions (especially massive investment in infrastructure) and government spending are some of the factors behind the pressure in aggregate demand. Still, some studies have suggested that inflation in Ethiopia is a supply side problem and the prevailing inflation is a result of expansionary output and price policy of the GOE that induces demand to trigger economic growth.

MEASURES TAKEN TO CURB INFLATION

¶5. An IMF mission that visited Ethiopia in February 2007 observed profound imbalances in the economy such as rising inflation; significantly high real negative interest rates. The mission advised the government to pursue demand dampening measures and growth enhancing structural reforms to ensure macroeconomic stability and sustain growth.

¶6. The GOE has attempted to curb inflation in a piecemeal manner by banning exports of cereals, levying surtax on selected imported goods and using the proceeds to distribute subsidized wheat to low income urban dwellers, taking administrative measures on speculating merchants, making adjustments to interest rates and reserve requirement ratios of commercial banks, and increasing civil service salaries. Assuming that the rise in the inflation was a result of cereal exports, the GOE banned exports of certain grains early in
¶2006. The National Bank of Ethiopia (central bank) raised the minimum deposit interest rate from 3 to 4 percent and the reserve requirement ratio of commercial banks from 5 to 10 percent in July
¶2007. The GOE also warns merchants against hoarding grains and speculating for higher prices.

¶7. On April 11, the GOE imposed a 10 percent surtax on selected imported goods generate funds to stabilize the domestic grain price.

Essential imports such as fuel, fertilizers, medicine, trucks, passengers' buses and other investment goods are exempted from the surtax. Hence impacts of the tax on investment and the on low and medium income groups is assumed to be minimal, according to the Finance Ministry. The GOE plans to collect billions of Birr from the surtax and use this money to subsidize grains to low income urban dwellers. Some economists disagree with the GoE arguing that by increasing the cost of some imports, the surtax risks further feeding inflation.

¶8. Additionally, the GoE recently increased salaries of civil servants. The salary increment ranges from a minimum increase of 17.5 percent for mid-level officials to 36.2 percent for high and low salary bands. It also includes up to a 70 percent increase for medical doctors and university professors. Similar adjustments will follow to employees of public enterprises. The GoE also raised pension payments including a 60 percent increase from USD 11 to USD 17.70 per month rise in the minimum pension. The total cost of the salary revision is estimated at $200 million per annum.

¶9. Analysts see this as a nominal, cost of living, wage increase rather than a real wage improvement that should come as a result of the continuous structural transformation of the economy. They view the current salary adjustment will exacerbate the existing inflation, due to businesses raising prices. Prices of some consumer goods have already gone up following announcement of the salary increase. Analysts recommend that the GOE pursue its reform agenda in liberalizing and transforming the structure of the economy in the areas of finance and telecom and expanding its tax base from the current coverage of 13 percent of GDP to at least the African average of 29 percent.

RESULTS- SURTAX NOT HAVING
DESIRED EFFECT; IMPACT OF
SALARY INCREASE TO BE SEEN

¶10. Despite various measures taken to abate rising prices, inflation

remains a threat to the livelihoods of low income Ethiopians, macroeconomic stability, and long term investments. Annualized headline inflation has steadily risen over the past two years, increasing from 3.9 percent in January 2005, to 18 percent in July ¶2007. Despite surtax food inflation increased from an annualized rate of 3.8 percent in January 2005 to 13.7 percent in January 2006, 14.8 percent in January 2007 and 20.2 percent in July 2007. The impact of the recent salary revision of civil servants is feared to aggravate the pressure on prices leading to built-in inflation.

¶12. COMMENT: The ever increasing inflation will undoubtedly negatively impact long-term investment through eroding confidence of investors and putting macroeconomic stability in danger. People whose income is fixed in nominal terms are bearing the burden while the recent revision in salaries and wages may aggravate the price hike. Emphasis should, thus be given to improving production rather than further creating demand which has significant impact in sustaining growth and fuelling inflation. The measures taken so far appear piecemeal and their impact in reducing inflation is not visible. Improving supply rigidities and increased private investment would enhance production of goods and services that will counter balance demand pressure. END COMMENT

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